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April 13, 2006

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The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, N.W.
Washington, D.C. 20423-0001

Re: ***CF Industries, Inc. v. Kaneb Pipe Line Partners, L.P.*, Docket No. 42084**

Dear Secretary Williams:

Enclosed for filing please find an original and ten (10) copies of CF Industries, Inc.'s Supplemental Reply Brief and Conditional Motion to Conduct Discovery. Please date stamp the extra copies of this cover letter and the filing and return them to our messenger. Thank you for your assistance in this matter.

Sincerely,

Jeffrey J. Williamson

cc: Service List

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UNITED STATES OF AMERICA
BEFORE THE
SURFACE TRANSPORTATION BOARD

CF Industries, Inc., **Complainant** **v.** **Kaneb Pipe Line Partners, L.P.** **and** **Kaneb Pipe Line Operating Partnership, L.P.,** **Respondents**	)	216243 **STB Docket No. 42084**

CF INDUSTRIES' SUPPLEMENTAL REPLY BRIEF AND CONDITIONAL MOTION TO CONDUCT DISCOVERY

Kaneb Pipe Line Partners, L.P.'s and Kaneb Pipe Line Operating Partnership, L.P.'s (collectively, "Kaneb") Second Supplemental Brief is a rehash of old arguments packaged with a frightening new assertion. Kaneb now explains that Valero, L.P. ("Valero") "paid" $175 million for the pipeline – more than a 215% increase in investment base since 2002 simply due to changes in ownership.[1] As CF Industries, Inc. ("CFI") has predicted since the beginning of this case (and Kaneb's new assertion demonstrates), use of acquisition cost in this context will lead to illegal rate spirals. The Surface Transportation Board ("Board") should reject Kaneb's attempt to pass along to captive customers the costs of yet another poor investment decision.

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1 Valero did not purchase the ammonia system pipeline for $175 million. Instead, Valero backed into the $175 million figure for accounting purposes. *See* Second Supplemental Brief of Kaneb Pipe Line Partners, L.P. and Kaneb Pipe Line Operating Partnership, L.P. on Impact of Merger ("Kaneb's Supplemental Brief"), Verified Statement of Thomas R. Shoaf at 2. It is questionable whether a purely accounting construct should be used as the "acquisition price" for ratemaking purposes. *See, e.g., CNG Transmission Corp.*, 64 FERC ¶ 61,110 (1993) (FERC stating that "accounting requirements do not determine the appropriate rate treatment"). Nevertheless, Kaneb does use $175 million as the new acquisition price, and, therefore, for purposes of this reply brief, so will CFI.

Even if the Board were inclined to consider Kaneb's ever-spiraling purchase price for rate-making purposes, the record is incomplete without further information. The first problem is that Valero admits that it has not completed its valuation work.[2] If the Board ultimately considers Kaneb's purchase price relevant, the Board cannot rule until Kaneb finally determines that price. The second, and much more fundamental problem, is that Valero's valuation makes no sense. Accepting Kaneb's arguments at face value, Valero paid a higher price for an alleged revenue inadequate pipeline with prescribed rates and declining volumes. If the Board is inclined to consider Valero's purchase price at all in this proceeding, CFI must be given the opportunity to conduct discovery into this highly suspect valuation and present evidence on its reasonableness.

In response to Kaneb's Second Supplemental Brief, CFI notes the following:

1. <u>Kaneb's filing confirms CFI's fears of a rate spiral.</u> The investment value of Kaneb's ammonia pipeline in early 2002 was approximately $55 million.[3] In 2002, Kaneb purchased the pipeline for $140 million,[4] and wanted to use the acquisition price to establish rates. In 2005, Valero "purchased" the pipeline for $175 million, and Kaneb wants to use the new acquisition price to establish rates. Thus, Kaneb proposes a 215% increase in investment base over three years. If the Board allows Kaneb to use this fictitious investment base to establish rates, it will result in exactly the type of upward rate spiral that the Supreme Court warned against in *Hope*[5] (*i.e.*, two increases in three years, resulting in a cumulative 215% increase in investment base

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2 *See* Kaneb's Supplemental Brief at 3.

3 *See, e.g.*, CF Industries, Inc.'s Supplemental Brief ("CFI's Supplemental Brief), Supplemental Verified Statement of Thomas W. Carlton at TC-3. Kaneb seems to imply that the value of the pipeline was $77 million. *See* Kaneb's Supplemental Brief at 7. That was the value of the pipeline in 1988, before fourteen years of depreciation.

4 *See* Kaneb's Supplemental Brief at 3-4.

5 *See Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("*Hope*").

due solely to changes in ownership and not to changes in the characteristics of the pipeline or costs of operating the pipeline). Kaneb's evidence proves CFI's rate spiral arguments addressed throughout this case and summarized in its Post-Oral Argument Brief.[6]

2. The pipeline purchasers were aware of the prescribed rates when they purchased the pipeline, and to the extent that they made a poor business decision, they should bear the burden. The investment base of the pipeline in early 2002 was approximately $55 million, it was sold in 2002 for $140 million, and "sold" again for $175 million in 2005. During both sales – 2002 and 2005 – the prescribed rates were in effect and a reasonable purchaser would have taken those prescribed rates into account when it set its purchase price. Thus, either (1) the prescribed rates did not negatively impact the value of the pipeline and thus there is no need to lift the prescribed rates or (2) the purchasers made poor investment decisions. Either way, Kaneb cannot now be heard to complain that the rate prescription is affecting its earnings. Kaneb's evidence validates CFI's earlier arguments that captive customers should not be a backstop for a pipeline's poor investment decisions.[7]

3. Kaneb has not justified its purchase price. Kaneb states that Valero's acquisition of the pipeline for $175 million confirms that its original purchase price was reasonable.[8] Wrong. First, Valero did not pay $175 million for the pipeline; that figure was reached using an accounting construct – and one that is still not complete. Second, if the pipeline was revenue inadequate at $140 million (as Kaneb claims), it makes no sense that Valero paid $175 million

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6 *See, e.g,* CF Industries, Inc.'s Post-Oral Argument Brief at 9-13 (June 3, 2005). For the benefit of the Board, rather than repeating another analysis of *Hope*, CFI's Post-Oral Argument Brief is attached as Attachment A.

7 *See, e.g,* CF Industries, Inc.'s Supplemental Brief at 5-6 (Feb. 4, 2005) ("CFI Supplemental Brief"); *see also* CF Industries, Inc.'s Response to Kaneb's Opening Evidence and Argument at 10-23 (Oct. 7, 2004) ("CFI's Opening Evidence").

8 *See* Kaneb's Supplemental Brief at 4.

for it. Perhaps Valero did not conduct sufficient due diligence. Perhaps Valero did not value the pipeline at $175 million and simply took the pipeline as part of a larger deal. Perhaps the pipeline is really revenue adequate. In any event, none of these justifies Kaneb's claim that the price was reasonable. Third, Kaneb relies upon an "independent appraiser's" valuation to support its purchase price, but as CFI has pointed out on prior occasions, those valuations are based on (incorrect) revenue projections provided by Kaneb.[9]

Nevertheless, it does not matter whether Kaneb is right and its original purchase price of $140 million was reasonable. If the $140 million (or the $175 million) figure was reasonable, it was reasonable in the context of the prescribed rates being in effect and thus Kaneb should be making its targeted returns even with the prescribed rates. If Kaneb's valuation was not reasonable, however, the Board should not bail out Kaneb by lifting the rate prescription. As CFI has stated in prior pleadings, the Board should establish the proper rules for evaluating whether a pipeline is revenue adequate, and the pipeline should accept responsibility for its own business judgments. If it makes good judgments, then the pipeline will prosper. If it makes poor judgments, the Board must not allow the pipeline to push the burdens of its poor judgment on to captive customers.[10]

4. <u>Kaneb's arguments regarding the rates established in 2000 are misleading.</u> Kaneb attempts to argue that the rates prescribed in 2000 were based on Koch's 1988 acquisition price, and not book costs.[11] CFI has rebutted this argument several times.[12] In 1988, the purchase

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9 *See* CFI Supplemental Brief at 7.

10 *See* CFI's Opening Evidence at 18-20 and n.22.

11 *See* Kaneb's Supplemental Brief at 7.

12 *See, e.g.,* CFI Supplemental Brief at 4 and n.8.

price equaled the book price because Kaneb's predecessor (unlike Kaneb) understood that acquisition costs rate spirals are at odds with decades of Supreme Court precedent. Thus, in 2000, when the Board issued its decision establishing the maximum prescribed rates, the "1988 acquisition price" and original costs produced the same result. The issue of acquisition price versus book costs was not relevant until this proceeding. Thus, Kaneb's statement that "[n]o matter what the Board eventually decides – acquisition price or original cost – Koch's 1988 acquisition price cannot properly be the rate's basis"[13] is both wrong and misleading.

5. Kaneb's figures are incorrect. The Board need not concern itself with Kaneb's quantitative assessment of its earnings since even Kaneb admits that the final numbers are not in yet (and because they are at odds with logic). Nevertheless, the numbers appear to be inflated. For example, Kaneb uses a $26 million valuation for line fill (up from $10 million).[14] This $26 million figure is calculated using the wrong price for ammonia.[15] Instead of using the price at which Kaneb could purchase the line fill at the origin of the pipeline, Kaneb uses a price paid by ammonia retailers for truckload quantities of ammonia from a terminal in the Midwest[16] – a price that includes, among other things, the cost of transport on its own pipeline. Thus, Kaneb is inflating the cost of replacing the line fill by as much as $40-60 per ton. Kaneb's valuation of the line fill reflects, at best, poor understanding of the ammonia industry.[17]

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13 Kaneb's Supplemental Brief at 7.

14 *See* Kaneb's Supplemental Brief at 3.

15 *See* Attachment B, Green Markets Price Scan showing the July 4, 2005 ammonia prices. Note the significant difference between upstream prices (*e.g.*, the U.S. Gulf) and downstream prices (*e.g.*, the Mid Cornbelt).

16 *See* Kaneb's Supplemental Brief, Verified Statement of Joseph Graham at 2.

17 *See, e.g.*, CFI Supplemental Brief at 9-10 (providing other illustrations of Kaneb not understating the ammonia industry).

6. Kaneb's pleading illustrates the potential harm to captive customers of lifting the rate prescription. Kaneb states that vacating the rate prescription will level the playing field and create an environment for fair negotiations between equals.[18] There is no level playing field between an unregulated monopolist and its captive customer. The Board has already found CFI to be captive – a determination that Kaneb never challenges. Moreover, Kaneb previews what will happen if the Board lifts the rate prescription by claiming that it has lost $21 million in extra revenue as a result of the prescribed rates.[19] It is now clear that Kaneb desires to increase CFI's rates by approximately one-third (assuming that Kaneb spreads the rate increase evenly across all shippers). As a captive customer, CFI cannot avoid the rate increase. That is hardly the result of a negotiation between equals.

In sum, Kaneb's brief provides no new evidence or argument to justify lifting the rate prescription, and, therefore, the Board should reject Kaneb's petition.

CONDITIONAL REQUEST FOR DISCOVERY

For the reasons stated above, this case should be decided on the law and facts already briefed in this proceeding. The Board has enough information to reject Kaneb's request to lift the rate prescription. However, to the extent that the Board believes that Valero's "purchase price" is relevant to this proceeding (other than reinforcing the risk of rate spirals), CFI submits this motion to conduct discovery on Valero's highly suspect valuation.

For example, CFI will conduct discovery into why Valero believes that the pipeline increased in value during a period that Kaneb states the pipeline was revenue inadequate, during

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18 *See* Kaneb's Supplemental Brief at 8.

19 *See id.* at 9.

a period when volumes were falling, and during a period when major shippers were shuttering their facilities. Moreover, CFI will conduct discovery into why Valero used downstream retailer prices instead of upstream producer prices in valuing the line fill. Finally, based upon those answers, CFI would like to depose Valero personnel to discover how they made their accounting and investment determinations and why they believe them to be appropriate.

There is already enough legal and factual support to deny Kaneb's request in this proceeding. To the extent that the Board disagrees, however, CFI requests the opportunity to exercise its due process rights and conduct discovery on Kaneb's evidence.

CONCLUSION

Before the ammonia pipeline system was bought by Kaneb, CFI considered buying it. CFI declined to purchase the pipeline – it was not worth $140 million. Kaneb, however, was not so prudent. Now, after being disappointed with its earnings, Kaneb seeks to pass the cost of its poor purchasing decision onto the very captive shipper who rejected the pipeline as too expensive. CFI made the prudent business decision in 2002; Kaneb did not. The Board should deny Kaneb's request.

Respectfully submitted,

CF Industries, Inc.

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Dated April 13, 2006

ATTACHMENT A

UNITED STATES OF AMERICA
BEFORE THE
SURFACE TRANSPORTATION BOARD

CF INDUSTRIES, INC.,
Complainant,

v.

KANEB PIPE LINE PARTNERS, L.P.

and

KANEB PIPE LINE OPERATING PARTNERSHIP, L.P.,
Defendants.

Docket No. NOR 42084

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CF INDUSTRIES, INC.'S POST-ORAL ARGUMENT BRIEF

The oral argument substantially narrowed the issues in this case. As a result, the following facts are no longer in dispute:

- Kaneb Pipe Line Partners, L.P. ("Kaneb") paid too much when it purchased its ammonia pipeline from Koch Pipeline Company, L.P. ("Koch").
- Kaneb paid too much because it gambled that volumes would jump nearly 50% above 2001 and 2002 levels, even though two of the largest shippers had shut-in their production facilities.
- Kaneb seeks the Surface Transportation Board's ("Board") blessing to shift the risk of its bad business decision to captive shippers such as CF Industries, Inc. ("CFI").
- Kaneb would be earning a revenue adequate return had it followed Koch's lead and purchased the pipeline for predecessor book cost, instead of nearly three-times book cost.

In light of these uncontroverted facts, this case rests on whether the Board will use Kaneb's excessive purchase price to establish the investment base when reviewing whether the pipeline remains revenue adequate and, thus, whether to lift the rate prescription. The record in this case demonstrates that the Board should not do so. Maintaining the rate prescription is further supported by an examination of two related legal issues that the Board asked the parties to address at oral argument: (i) whether Kaneb's excessive purchase price constitutes a "changed circumstance" that justifies lifting a rate prescription and (ii) whether the Supreme Court's concern about the circular reasoning in using "value" to establish rates, expressed in *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("*Hope*"), guides the Board's evaluation of Kaneb's revenue adequacy.

Standard for Lifting Rate Prescription: "The Board may, at any time on its own initiative because of material error, new evidence, or substantially changed circumstances . . . (3) change an action of the Board."[1] In applying this statute to a request for lifting a rate prescription, all parties agree that the Board should determine whether "the factual and legal underpinnings of the original prescription continue to have current validity."[2]

Kaneb's rate prescription is based upon two factual underpinnings. In the *Koch Order* establishing the rate prescription, the Board found the pipeline to be (i) market dominant and (ii) revenue adequate.[3] Kaneb does not challenge the Board's market dominance finding. Moreover, the evidence submitted in this proceeding demonstrates that the pipeline continues to be revenue adequate if Kaneb's investment base is set using predecessor book costs (even accounting for changes in operating costs, capital expenditures, revenues, and volumes). Thus, Kaneb's entire case rests upon its argument that an appropriate changed circumstance for the Board to consider, one that justifies lifting a rate prescription, is that it paid too much for the pipeline. Accepting

1 49 U.S.C. § 722(c)(3); *see also* 49 C.F.R. § 1115.4 (2004).

2 *San Antonio, Texas v. Burlington N.*, 364 I.C.C. 887 at 896 (1981) ("*San Antonio v. Burlington Northern*").

3 *See CF Industries, Inc. v. Koch Pipeline Co., L.P.*, STB Docket No. 41685, 4 S.T.B. 637, 2000 STB Lexis 260 at *59 (2000) ("*Koch Order*").

this argument would have the perverse effect of shifting the risk of Kaneb's bad investment decision (which was entirely within Kaneb's control) to captive shippers such as CFI.[4]

Thus, the Board should reject Kaneb's request to use its excessive purchase price to establish the investment base when reviewing whether the pipeline remains revenue adequate. If the Board uses predecessor book costs to evaluate Kaneb's revenue adequacy, (a) Kaneb's pipeline remains revenue adequate, (b) Kaneb cannot show a change to either of the two factual underpinnings of the original rate prescription, (c) captive shippers will not be forced to pay for Kaneb's bad investment decision, and (d) the Board will mimic the results that would occur in a competitive market.

Application of *Hope*: The second legal issue that the Board asked the parties to address is whether the Supreme Court's *Hope* decision precludes the Board from using Kaneb's excessive purchase price to evaluate revenue adequacy. It does. While *Hope's* warnings about avoiding "circularity" when setting rates for a pipeline may not apply in proceedings where shippers have competitive transportation alternatives, that is not the case with Kaneb's pipeline where the Board has already determined that 19 of 21 markets are captive and CFI is paying the maximum rate. Ignoring *Hope* would result in an upward spiral in the pipeline's rates. Thus, the circularity problem addressed by the Supreme Court in *Hope* is a central issue in this proceeding. Kaneb's attempt to vacate the rate prescription by relying upon its excessive purchase price is exactly the type of circularity in reasoning that the Supreme Court found impermissible in *Hope*.

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4 This would be particularly ironic considering that CFI had the opportunity to, but decided not to, purchase the pipeline.

ARGUMENT

I. Kaneb Has Not Justified Lifting The Rate Prescription.

In *San Antonio v. Burlington Northern*, the Interstate Commerce Commission ("ICC") stated that the standard for lifting a rate prescription is whether "the factual and legal underpinnings of the original prescription continue to have current validity."[5] This standard requires the Board to examine whether the key holdings that led to the original rate prescription are still true and, if there are changes, whether the changes would have caused the Board to reach a different outcome in the original case.[6]

The Board had an opportunity in *Arizona Public Service Co. v. Burlington Northern* to examine the type of evidence that could be used to assess changed circumstances.[7] In that case, the Board first decided which types of changed circumstances it would be willing to consider, rejecting requests to allow an entirely new stand-alone cost ("SAC") analysis.[8] Then, the Board examined how the changed circumstances cited by the parties impacted the original SAC analysis upon which the Board's rate prescription decision relied. The carrier challenging the rate prescription (unlike Kaneb) submitted concrete evidence of changes and demonstrated how that evidence impacted the SAC analysis underlying the rate prescription. As the Board noted when reopening the rate prescription, the "changed circumstances relate[] to a specifically

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5 *San Antonio v. Burlington Northern*, 364 I.C.C. at 896.

6 *See, e.g., West Texas Utilities Co. v. Burlington N. & Santa Fe Ry. Co.*, STB Docket No. 41191, 2003 WL 21483068 at *4 (June 27, 2003) ("The Board has consistently held that the remedy for a party that feels that the factual circumstances underlying a maximum rate case have changed substantially is to petition to reopen the proceeding and show the pattern of changes that would lead to a different result.").

7 *See Arizona Pub. Serv. Co. v. Burlington N. & Santa Fe Ry. Co.*, STB Docket No. 41185, 2003 WL 21055725 (May 9, 2003) ("*APS Reopening Order*"); *Arizona Pub. Serv. Co. v. Burlington N. & Santa Fe Ry. Co.*, STB Docket No. 41185, 2004 WL 2852166 (Dec. 13, 2004) ("*APS Vacating Order*").

8 *See APS Reopening Order* at *4.

identified and contested assumption in our prior decisions."[9] The Board found that "the updated evidence submitted on reopening shows that the changed circumstances have such a profound effect on the SAC analysis upon which the previous rate prescription was based that the prescription should be vacated and the proceeding dismissed."[10] The new SAC analysis in *Arizona Public Service Co. v. Burlington Northern* is the type of evidence that parties submit in seeking to lift a rate prescription and the type of evidence that Kaneb failed to submit in this case.

A review of prior decisions suggests that the Board follows four basic steps in evaluating whether to lift a rate prescription: (1) identifying the premises underlying the original rate prescription; (2) identifying the factual changes being relied upon to modify the rate prescription; (3) identifying which of these changes the Board will permit the parties to evaluate; and (4) determining whether the permissible changes undermine the factual underpinnings of the original rate prescription.

<u>Step 1</u>: Identify the premises underlying the original rate prescription. The Board's basic test, as articulated in *San Antonio v. Burlington Northern*, is whether there have been changes to the factual and legal underpinnings of the rate prescription. Thus, the first step must be to identify those underpinnings.[11] While this may seem like an obvious first step, Kaneb never took the step in this case and its analysis suffers as a result. Specifically, when establishing the original rate prescription, one of the Board's two key factual findings was that the pipeline was revenue adequate, relying upon a multi-year discounted cash-flow analysis. The

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9 *Id.* at *3.

10 *APS Vacating Order* at *1.

11 *See, e.g., id.* at *1 ("The Board's rate analysis was based on the SAC methodology developed in Coal Rate Guidelines, Nationwide. . . .") (citation omitted).

Board did not premise its rate prescription on a one-year snapshot or on any individual component of the revenue adequacy test (*e.g.*, a specific revenue, tax, or operating cost level). Rather, the Board considered all of the facts and concluded that the pipeline was revenue adequate. If Kaneb wishes to challenge the rate prescription it must show that there has been a change to its revenue adequacy – not to the individual components that contribute towards that premise. Kaneb fails in this regard because it failed to submit a multi-year analysis of its revenue adequacy as required by the Board.

Step 2: Identify the factual changes that are being relied on to lift the rate prescription. Like Step 1, identifying the changes to the factual bases underlying the prescription is an integral part of the *San Antonio v. Burlington Northern* standard.[12] In this case, Kaneb has identified five changes: operating costs, capital expenditures, revenues, volumes, and investment base.[13]

Step 3: Identify which of these changes the Board will permit the parties to evaluate. In *Arizona Public Service Co. v. Burlington Northern*, the Board was clear that it would not permit a complete re-litigation of all issues in the original case. The Board noted, however, that there were factual issues contested in the prior case that changed after the rate prescription was put in place. Therefore, the Board permitted the parties to reflect these new facts, to update forecasts

12 *See, e.g., id.* at *2 ("In January 2003, BNSF filed a petition asking the Board to reopen this proceeding and to vacate the rate prescription, based on evidence that: (1) the McKinley mine will exhaust its reserves well before the end of the 20-year SAC analysis period; (2) P&M will be unable to replace McKinley mine coal with coal from the Navajo Nation due to its high sulfur content; and (3) actual movements of coal from that mine to Cholla in recent years had not reached the predicted levels.").

13 *See* Kaneb Pipe Line Partners, L.P.'s and Kaneb Pipe Line Operating Partnership, L.P.'s Opening Evidence and Argument at 12-23 (Sept. 13, 2004) ("Kaneb's Opening Evidence").

from the earlier case that proved to be inaccurate, and to reflect items such as the current cost of capital.[14]

Deciding which changes are permissible for consideration requires careful analysis. In deciding which changes to consider when determining whether to lift a rate prescription, the Board has previously considered factors such as whether the changed circumstances were the subject of factual disputes in the original rate prescription case, are significant, or are outside the control of the carrier.[15] Indeed, this is what the Board signaled it would do in the *Koch Order*, where it noted that it would lift the rate prescription if Koch became revenue inadequate due to increased costs that Koch had predicted, but had not substantiated.[16] In addition, the Board must consider the relevant case law, such as the Supreme Court's *Hope* decision (see discussion below), and its statutory responsibilities, such as its obligation to ensure "consumer protection."[17]

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14 *See APS Reopening Order* at *4 ("We therefore need a more developed record on how Arizona and Salt River will re-source their coal needs once McKinley shuts down, what portion of that traffic could flow over the SARR, and what revenues the SARR could reasonably expect to earn from that coal traffic. In all other respects, the reopening must be limited to the basic assumptions upon which Arizona based its SAC case in 1994. Arizona based its SAC case on a particular configuration and upon the assumption that the SARR would serve a traffic group limited to coal movements to only two utility plants. This reopening is not an opportunity to expand the configuration of the SARR, or to include new traffic, other than the re-sourced coal traffic destined to Arizona and Salt River. Both parties may, however, update the record regarding any forecasts made in our prior decisions, such as inflation indexes, cost of rail equity, and revenue forecasts for the Salt River traffic that proved to be inaccurate. But the parties may not seek to reargue or recalculate the costs upon which the projections were based.") (citations and footnote omitted).

15 In *West Texas*, for example, the Board made clear that it would not lift a rate prescription unless there was a significant change in circumstances. *See West Texas Utilities Co. v. Burlington N. & Santa Fe Ry. Co.*, STB Docket No. 41191, 2003 WL 21359571 at n.8 (May 28, 2003) ("Projections will inevitably prove inaccurate to some degree. But the Board previously rejected 'the notion that any discrepancy between forecasted and actual traffic volumes warrants reopening and recalculation of the SAC analysis.' Rather, changes must be significant; they should 'involve important long-term shifts in traffic patterns, not short-term, year-to-year fluctuations that do not undermine long-term projections.'") (citations omitted).

16 *See Koch Order*, 2000 STB Lexis 260 at *56.

17 The House Conference Report for the Interstate Commerce Commission Termination Act of 1995 states that one of the intents of the statute is to ensure "consumer protection." *See* H.R. Conf. Rep. No. 104-422 (1995).
(Continued...)

In this proceeding, CFI has shown that using Kaneb's excessive purchase price to establish the investment base would produce inequitable results that shift risks to captive customers, insulate Kaneb from its own poor investment decisions, and be contrary to the Supreme Court's warnings regarding circularity in *Hope*. Therefore, the Board should reject Kaneb's attempt to use its purchase costs to establish the new investment base.[18]

<u>Step 4</u>: Determine whether the permissible changes invalidate the original factual finding.[19] Here, the party advocating a change to the rate prescription should update the models underlying the original rate prescription to see if the results are different with the permissible changed circumstances. As discussed above, this is exactly what the carrier did in *Arizona Public Service Co. v. Burlington Northern*, where the railroad updated the SAC model to demonstrate that the outcome of the earlier case would have been different with the new factual analysis. Kaneb, in contrast, failed to present this type of evidence. Therefore, the Board should maintain the rate prescription.

Notwithstanding Kaneb's evidentiary failure, CFI evaluated whether Kaneb would be revenue adequate using all of the changed circumstances other than investment cost. Using all of Kaneb's changes except its change to the investment base (see Step 3), the pipeline is still

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See CF Industries, Inc.'s Response to Kaneb's Opening Evidence and Argument at 17 (Oct. 7, 2004) ("CFI's Opening Brief") for more discussion of this issue.

18 This is a fact specific analysis. CFI is not arguing that the Board should always use book costs to set the investment base. In cases where there are no captive customers, where the purchase price is lower than the book costs, or where there are other methods for protecting customers (such as prior regulatory review of a merger or sale), it may be permissible under Step 3 to use the purchase costs. In those cases, the risks are not the same as in this case. That is why, in each case, the Board must consider the effects of using a particular "changed circumstance" and whether using that change comports with the relevant case law and statutory obligations.

19 *See, e.g., APS Vacating Order* at *5 ("Both parties now project a significant under-recovery of costs for the remainder of the SAC analysis.").

revenue adequate.[20] Kaneb's entire argument for changed circumstances is based upon its desire to reflect something within its control as a changed circumstance. The Board is not in the business of using such carrier decisions to impose higher rates on captive shippers such as CFI.

Having completed the four-step process, the Board is in a position to determine whether specified "changed circumstances" justify lifting a rate prescription. In this case, the four-step process illustrates that the only "changed circumstance" that has a material impact on the pipeline's revenue adequacy is the proposed change to the investment base. However, the record in this case demonstrates that using Kaneb's purchase price to set the investment base improperly shifts risk to captive shippers and contravenes relevant case law and statutory obligations. Therefore, the Board should not use the purchase price to establish the investment base. When using predecessor book costs to set the investment base, the pipeline remains revenue adequate. There is no justification for lifting the rate prescription.

II. *Hope* Is Applicable To This Case.

The Board also asked the parties whether *Hope* applied to this proceeding. All parties agree that *Hope* binds the Board if the facts apply to Kaneb's pipeline. Because Kaneb is market dominant and is attempting to pass through its excessive purchase price to its captive customers,

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20 CFI is not stating that it accepts Kaneb's description of its "changed circumstances." Some of the factors cited by Kaneb, such as the increased capital expenditures, appear to be the result of one-time expenditures such as fixing a bottleneck on the pipeline. *See* Kaneb's Opening Evidence at 17. And Kaneb concedes that its increased property taxes are tied to its excessive purchase price. *See* Kaneb's Response to CFI's Second Set of Data Requests at 4, attached to CF Industries, Inc.'s Supplemental Brief at Ex. B (Feb. 4, 2005). Moreover, some changes may be offset by other factors ignored by Kaneb, such as the lower income taxes. And, as CFI has argued, Kaneb has presented no evidence that the changes are permanent. *See* CFI's Opening Brief at 9-10. Regardless, CFI has presented evidence showing that even if all of the changes other than the change to the investment base are accepted without any review, the pipeline is still revenue adequate. *See* CF Industries, Inc.'s Supplemental Brief at Ex. A (Feb. 4, 2005).

the facts mirror those in *Hope*. Therefore, the Board should not use Kaneb's excessive purchase price to evaluate revenue adequacy.

The Supreme Court in *Hope* overturned the Circuit Court's determination to set a rate base using the "present fair value" of a pipeline's property. In doing so, the Court noted that setting regulated utilities' rates based on "value" creates a "circularity" problem: "'[F]air value' is the end product of the process of rate-making not the starting point as the Circuit Court of Appeals held. The heart of the matter is that rates cannot be made to depend upon 'fair value' when the value of the going enterprise depends on earnings under whatever rates may be anticipated."[21] In *Hope*, the Supreme Court noted that the value of a pipeline ultimately depends on the rates themselves, and that setting rates based on a determination of the "value" of a pipeline merely builds that valuation into the rates.[22]

As the Board has recognized, the circularity problem is mitigated in cases where the prescribed or filed rates and the value are decoupled. This occurs when the carrier's revenues are not dictated by an established rate because there is a competitive market. The Board and its predecessor have addressed this in the rail context, where it has distinguished *Hope*.

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21 *Hope*, 320 U.S. at 601.

22 In other words, the pipeline's "value" is a function of rates. Expressed mathematically, value = *f*(rates). Kaneb demonstrated this relationship in its investment analysis where, to arrive at its purchase price, it conducted a discounted cash flow analysis of Koch's projected revenues from the rates then in effect. *See* CF Industries, Inc.'s Supplemental Brief, Ex. B. at KNB-00305 through KNB-00307 (Feb. 4, 2005). While one can work "backwards" to calculate a rate, *i.e.*, plug any number into the value and determine the rate that achieves a given return, this merely makes the rate reflect the value (or purchase price in Kaneb's case). It does not tell the Board whether the value is reasonable, just, prudent, reflects a competitive market, or complies with law, regulation, or policy. At that point, it is just an algebraic equation that can be used to get a rate that justifies any value. Because it is necessary to consider whether a rate is appropriate, just, complies with law or public policy, or protects captive consumers, the Supreme Court recognized that an agency cannot work backwards to set a rate because that merely builds the valuation into the rate. It creates a circularity problem. Kaneb, by plugging in its own valuation, even though it exceeded book costs, is attempting to work backwards. While the Supreme Court recognized the "circularity" in the reasoning, a further problem is that it shifts investment risk to captive customers, which is contrary to the statute and poor public policy.

For example, in the 1990 revenue adequacy decision establishing a presumption for use of acquisition costs, the ICC noted that "most rail rates are not subject to maximum rate regulation" and used this fact to distinguish its policy from *Hope*.[23] Realizing the potential for facts that could require adherence to *Hope*, the ICC retained for itself the flexibility to use a different measure: "Nonetheless, we do not mean to suggest that we will accept the sale price of rail assets as a substitute for old book value in every case. Our decision will be driven by what is the most accurate and reasonable valuation in each particular case."[24] When affirming the ICC's decision, the D.C. Circuit likewise distinguished *Hope* based upon the ICC's finding that "[r]ailroads are not a 'heavily regulated utility' and therefore 'most rail rates are not subject to maximum rate regulation.'"[25]

The Board confronted the question of applying *Hope* even more squarely in *Conrail*.[26] In that case, the carriers paid a significant premium above book and the Board faced arguments that the railroads would be able to pass through the acquisition premium to captive customers. The Board found that "because relatively few shippers were captive to rail even before this transaction, CSX and NS could not successfully pursue a strategy of making up a revenue shortfall simply by increasing their rates to captive shippers."[27] The Board went on to say that "Protestants' suggestion that applicants would pay a multi-billion dollar premium based upon the expectation of extracting increased monopoly rents (because of adjustments in the regulatory rate

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23 *Railroad Revenue Adequacy – 1988 Determination*, 6 I.C.C.2d 933 at 941 (1990).

24 *Id.*

25 *Ass'n of Am. Railroads v. I.C.C.*, 978 F.2d 737 at 741 (D.C.Cir. 1992).

26 *See CSX Corp., et al.*, STB Finance Docket No. 33388, 1998 WL 456510 (1998) ("*Conrail*").

27 *Id.* at *38.

base) from the very small number of shippers that are truly captive is not credible."[28] Then the Board distinguished *Hope*, noting *Hope's* discussion of "the circularity problems where acquisition price is based upon the prospect of increased returns."[29] Thus, in *Conrail*, the Board suggested that it would reach a different result if it faced the circularity problem raised by *Hope*.

Where competition exists, the actual rates may be below maximum rates that otherwise would exist because competition has a disciplining effect that drives down prices. But that is not the case in this proceeding. In this proceeding, Kaneb charges customers the maximum prescribed rates. And, in this proceeding, Kaneb is explicitly trying to build its excessive purchase price into its rates. Because the rates and value are so intricately tied together in this proceeding, and the market lacks legitimate competitive alternatives, this case is distinguishable from railroad cases where the circularity problem is less of a concern.

There is one other aspect of *Hope* that is relevant to this proceeding – the notion that an investor is entitled to an opportunity to earn, but is not guaranteed, a fair return on its investment. In *Hope*, the Supreme Court cautioned that "'regulation does not insure that the business shall produce net revenues.'"[30] Instead, the return to the investor should "be commensurate with returns on investments in other enterprises having corresponding risks.'"[31] "Rates which enable the company to operate successfully . . . cannot be condemned as invalid, even though they might produce only a meager return on the so-called 'fair value' rate base."[32] The Supreme Court's analysis applies to Kaneb. Kaneb, like other investors, is entitled to a return provided

28 *Id.*

29 *Id.*

30 *Hope*, 320 U.S. at 603.

31 *Id.*

32 *Id.*, 320 U.S. at 605.

that it made a wise investment decision. If not, it must assume the risks of its poor investment decisions. It is not immunized against lower than expected returns simply because it is regulated. Moreover, the Board should not lose sight of the fact that Kaneb's own evidence shows the pipeline to be profitable and able to operate successfully, even if not necessarily producing the returns that Kaneb had hoped for.[33] In summary, *Hope* binds the Board's decision in this proceeding.

III. Conclusion.

Kaneb made a mistake when it paid too much for its ammonia pipeline. In competitive markets (including the rail industry), the carrier must accept the risks associated with bad business decisions. The Board should impose the same standard here. Therefore, the Board should reject Kaneb's attempt to use its excessive purchase price as a justification for lifting its rate prescription. This result is required by the Board's own jurisprudence and the Supreme Court's decision in *Hope*.

Respectfully submitted,

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33 *See, e.g.*, CF Industries, Inc.'s Supplemental Brief, Ex. B. at KNB-00305 through KNB-00307 and KNB-00360 through KNB-00361 (Feb. 4, 2005)

CERTIFICATE OF SERVICE

I certify that I have this day served copies of CF Industries, Inc.'s Post-Oral Argument Brief on all parties in this proceeding by hand delivery.

Dated at Washington, DC, this 3rd day of June, 2005.

Jeffrey L. Williamson

ATTACHMENT B

GREEN MARKETS PRICE SCAN

Unless otherwise noted, all domestic U.S. prices are on a short ton, FOB basis. International prices are on a metric ton basis.

AMMONIA	7/4/05	Year ago
U.S. Gulf NOLA barge	305	270
July NYMEX ng close	6.976	6.141
June NYMEX ng close	6.123	6.680
Tampa mt C&F	275	285
Other U.S. Gulf mt C&F	285-292	295
Mid Cornbelt	330-375	295-310
Great Lakes	375-395	305-320
Northern Plains	335-355	305-320
Southern Plains	305-330	270-300
Southern Plains DEL	325-340	295
South Central	360-365	300-310
South Central DEL	N.A.	N.A.
California DEL	370-380	290-310
Pacific N.W. DEL	357-375	350-380
W. Canada DEL C$/mt	645-676	515-533
Caribbean	250-267	260-270
Western Europe C&F	255-260	280-285
Black Sea	210-215	245-250
Middle East	252-259	265-270

UREA	7/4/05	Year ago
U.S. Gulf prill import	250	190-198
U.S. Gulf gran barge	250-252	190-198
Mid Cornbelt	280-295	205-215
Great Lakes	295-315	210-215
Northern Plains	285-290	205-210
Northern Plains DEL	305-310	225
Northeast	305-315	215
Southern Plains	260-275	200-205
South Central	265-280	205-210
California DEL	340-345	230-255
Pacific N.W. DEL	315-325	245-265
W. Canada DEL C$/mt	438-455	365-380
Caribbean granular	N.A.	N.A.
Black Sea	230-235	175-180
Middle East prill	240-242	175-180
Middle East granular	240-242	178-180
Indonesia bulk	251-253	N.A.

UAN	7/4/05	Year ago
U.S. Gulf NOLA barge	5.03-5.09	N.A.
U.S. Gulf NOLA barge st	161-163	N.A.
Mid Cornbelt	6.00-6.72	4.95-5.25
Great Lakes	6.68-6.98	5.10-5.40
Northern Plains	6.50-6.80	5.00-5.25
Southern Plains	5.94-6.41	4.60-4.90
South Central	5.63-5.94	4.50-4.69

	7/4/05	Year ago
Southeast	5.67-5.73	4.60-5.47
Northeast	5.93-6.95	4.67-5.40
California	7.34-7.50	5.45-5.78
California DEL	7.97-8.13	5.78-6.25
Pacific N.W.	N.A.	5.35-5.65
Pacific N.W. DEL	7.13-7.50	5.65-6.00
W. Canada DEL C$/mt	9.79-10.11	8.04-8.25

AM. NITRATE	7/4/05	Year ago
U.S. Gulf NOLA barge	205	150-155
Mid Cornbelt	225	180-190
Southeast DEL	247-260	200-205
Southern Plains	N.A.	170-175
South Central	230-240	175-185
South Central DEL	N.A.	190-200
California DEL	270-275	230-250
Pacific N.W. DEL	260-265	200-210
W. Canada DEL C$/mt	355-368	300-312

AM. SULFATE	7/4/05	Year ago
Mid Cornbelt	210-218	165-175
Great Lakes	210-218	165-175
Southern Plains	175-200	140-150
South Central	185-195	147-152
Southeast	185-195	145-155
California	180-185	140-155
Pacific N.W. DEL	185-195	150-170

DAP	7/4/05	Year ago
Central Florida	213-218	185
New Orleans barge	223-228	195-198
Mid Cornbelt	243-255	215-222
Great Lakes	248-258	222-229
Northern Plains	240-245	216-218
South Central	230-240	210-218
Southern Plains	242-247	212-215
California DEL	280-285	255-265
Pacific N.W. DEL	268-278	250-270
Eastern Canada C$/mt	350-355	350-355
U.S. Gulf export	252-253	220-222
North Africa	N.A.	220-222

CERTIFICATE OF SERVICE

I certify that I have this day served copies of CF Industries, Inc.'s Supplemental Reply Brief and Conditional Motion to Conduct Discovery on all parties in this proceeding.

Dated at Washington, DC, this 13th day of April, 2006.

Jeffrey J. Williamson